United States Court of Appeals

for the Second Circuit

APPELLEE’S BRIEF

74-1221 74-1490

To be argued by
THOMAS E. TYRE

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 74-1221 and 74-1490

CITIES SERVICE COMPANY,
Plaintiff-Appellee-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant-Appellee.

CONSOLIDATED APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR CITIES SERVICE COMPANY

THOMAS E. TYRE
330 Madison Avenue
New York, New York 10017
Telephone: 490-8445
Attorney for Cities Service Company

Of Counsel:

CASEY CRAIG & CONSTANCE
330 Madison Avenue
New York, New York 10017

JAMES W. ROBINSON
FRUEAUFF, FARRELL, SULLIVAN & BRYAN
60 Wall Street
New York, New York 10005

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BRIEF FOR CITIES SERVICE COMPANY

Preliminary Statement

This is a consolidated appeal by the United States, defendant in the Court below, and cross-appeal by Cities Service Company, plaintiff in the Court below, from the opinion and judgment of Judge Charles Tenney of the United States District Court for the Southern District of New York, which were entered on June 12, 1973 and November 20, 1973, respectively. Said opinion is reported at 362 F.Supp. 830 (1973) and incorporates therein prior opinions and orders by Judge Walter R. Mansfield and Judge Inzer B. Wyatt, of the United States District Court for the Southern District of New York which are reported at 316 F.Supp. 61 (1970) and 330 F.Supp. 421 (1971) respectively.

Issues Presented For Review

1. Did the District Court err in not holding that the amount received by Cities Service Company due to the change of its preferred and preference shares into 3% debentures was $45,323,846, the amount received by it upon the issuance of such preferred and preference shares?

2. Alternatively, did the District Court properly hold that, as a matter of law, the amount received by Cities Service Company for its 3% debentures was $86,313,600, the fair market value of its preferred and preference shares on May 27, 1947?

3. Did the District Court err in not holding that upon the retirement of some of the 3% debentures in 1953 and 1954, Cities Service Company incurred in those years deductible losses under Section 165 of the Internal Revenue Code (and its predecessor Section 23(f) of the Internal Revenue Code of 1939) measured by the difference between the amount received for the debentures retired and the amount paid to retire them?

4. Alternatively, did the District Court properly hold that the difference between the amount it deemed received, and the principal amount of the debentures constitutes debt discount amortizable over the term of the debentures with adjustments for premature retirements?

5. Did the District Court err in computing the judgment entered herein by excluding from the debt discount deduction for the years 1953 and 1954, any discount attributable to the debentures retired which was deductible but not deducted by Cities Service Company in the years 1947 through 1952?

Statement of the Case

A. *Nature of the Case and Proceedings Below*

This case arises out of a suit for refund of Federal income taxes paid by Cities Service Company for the calendar years 1953 and 1954. The basis of the suit was a claim for a tax deduction of the loss or expense incurred upon the purchase and retirement in said years of some of its 3%, Thirty-Year Sinking Fund Debentures, due 1977, which were issued pursuant to an order of the United States District Court for the District of Delaware in exchange for all of its outstanding preferred and preference shares. Cities' suit was premised upon the contention that the amount received for such debentures was less than their principal amount, and a deductible loss or amortizable expense was incurred upon their purchase at prices in excess of the amounts received.

The complaint was filed on November 22, 1967. On November 26, 1969, defendant, United States, filed a motion for summary judgment which was denied by then District Judge Walter R. Mansfield in an opinion dated July 23, 1970. Judge Mansfield held, *inter alia*, that when a taxpayer receives its own shares in exchange for its debentures any loss or discount expense is to be determined by reference to either the original issue price of the preferred and preference shares or the value that may have accrued to the taxpayer on account of the exchange of debentures for such shares, if any, in excess of the original issue price. He also held that the actual value to the taxpayer can be determined only after consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profit prospects and expert opinion. The market price of

the shares was held to be relevant but not conclusive. (167a)

On December 9, 1970 defendant filed a second motion for summary judgment.

By order dated February 11, 1971, Judge Mansfield directed "that this case be set for trial in due course with the sole factual question to be resolved thereat being the value to plaintiff (Cities Service Company) of the preferred and preference shares received by it in exchange for the issuance of its 3%, thirty-year, sinking fund debentures ("the Bonds") on May 27, 1947; and that the bonds shall be deemed issued at a price equal to the value to plaintiff of the preferred and preference stocks received in exchange for their issuance on May 27, 1947; and that the value of those shares to plaintiff shall be no less than $45,323,846, the value of the consideration originally received for their issuance." (173a, 174a)

On June 21, 1971, defendant's second motion for summary judgment was denied by District Judge Inzer B. Wyatt in an opinion reaffirming Judge Mansfield's determination.

On July 17 and 18, 1972 a trial was held before District Judge Charles H. Tenney, at which plaintiff, Cities Service Company, adduced expert testimony and documentary evidence which established that upon the exchange of the 3% debentures for the preferred and preference shares, Cities received no additional value in excess of the $45,323,846 originally received for the shares when they were issued. In his opinion, dated June 11, 1973, Judge Tenney found all of the pertinent facts to be as contended for by plaintiff but held that, as a matter of law, the value to plaintiff of the preferred and preference shares received by it on the exchange was $86,313,600, the fair market

value of the preferred and preference shares on May 27, 1947, which fair market value was established in the record and conceded to be accurate by defendant, United States.

The judgment was entered by Judge Tenney on November 20, 1973, in which the deductible amounts for 1953 and 1954 were determined by combining the annual amortization of bond discount (the difference between the principal amount of the bonds, $115,246,950 and the fair market value of the preferred and preference shares, $86,313,600 allocated over the 30 year term) attributable to the bonds on hand during the years *plus* any remaining unamortized discount attributable to the bonds retired in such year. Discount amortization attributable to prior years but not deducted by Cities was excluded.

On January 15, 1974, defendant United States, filed a notice of appeal from the judgment of the District Court. On January 23, 1974 Plaintiff, Cities Service Company, filed notice of cross-appeal to preserve its right to maintain in this Court that the issue price of the 3%, Thirty-Year Sinking Fund Debentures is the amount originally paid in to Cities upon the issuance of the preferred and preference shares and to contest the method of calculating the amount of the deductions for 1953 and 1954.

B. *Statement of the Facts Found by the Court Below and of Record*

The pertinent facts as found by the District Court and established by the record are as follows:

In late January, 1941, Cities Service Company ("Cities") became a registered holding company under the Public Utility Holding Company Act of 1935, 15 U.S.C. §79, 49 Stat. 820, thereby subjecting itself to special regulation by the Securities and Exchange Commission ("SEC"). Pursuant to that Act and to various orders issued by the SEC,

Cities was required to divest itself of certain of its public utility interests and to undertake a simplification of its corporate and capital structures. (142a, 143a)*

Accordingly, on November 20, 1946, Cities presented a "Plan pursuant to Section 11(e) of Public Utility Holding Company Act of 1935 for simplification of corporate structure" to its shareholders and to the SEC. At the time of the submission of this original plan, Cities had outstanding, in addition to slightly over 100 million dollars in debentures and about 37 million dollars par value of common stock, three classes of no-par, voting, cumulative, preferred and preference stock whose stated value aggregated approximately 58.7 million dollars. The dividends on these three classes of preferred stock (and also on common stock) had been passed for 14 years, and the arrearages totalled approximately 49.7 million dollars. The original plan submitted provided for cash redemption of outstanding debentures and for the exchange of the preferred and preference stocks for a new issue of 3% fifty-year sinking fund debentures in a principal amount equal to the stated value of the preferred and preference shares plus accumulated and unpaid dividends, or approximately 108.4 million dollars. The plan further provided that approval of the exchange by the holders of 60% of the preferred shares would be required before the plan would become effective. (143a)

Beginning in December, 1946, and continuing for some months thereafter, the SEC conducted hearings on the fairness of the plan. On the opening day of the hearings objections to the original plan were raised by various preferred shareholders. They pointed out that while debenture holders, upon retirement of their securities, were

* Parenthetical References with the suffix "a" are to the Joint Appendix.

being given their full call price in cash, the preferreds were to receive only the liquidation value of their shares, and even that in the form of securities which could not be expected to sell at par under prevailing market conditions. Cities earnings, they argued, had long been and would continue to be sufficient to pay dividends on the preferred if the management would only forego its established policy of using all surplus earnings to retire debt. Under the circumstances, they contended, Cities should pay the full call price of the preferred shares as well as that of the outstanding debentures to be retired. It was also suggested that the interest rate on the debentures to be issued in exchange for the preferred stock be raised to 3½%, presumably to increase the chances that the debentures could be sold at par. (144a)

On February 14, 1947, after extensive testimony by Cities' executives, outside engineers and investment bankers as to the fairness of the original plan, and shortly before a preferred shareholders committee was to proceed with its opposing proof, Cities amended its original plan to partially meet the objections of the preferred shareholders. The amended plan reduced the maturity of the 3% debentures from fifty to thirty years, awarded the preferred stockholders debentures in a principal amount *equal to* the call premium on their shares plus their stated value and plus dividend arrearages, provided for additional restrictive covenants in the debenture indenture, dispensed with the necessity of shareholder approval of the exchange, and restricted the rights of Cities to declare common stock dividends and to incur new debt during the life of the debenture issue. (144a, 145a)

The preferred shareholders thereupon withdrew their objections to the amended plan. On April 24, 1947, the amended plan was approved by the SEC. Later the United

States District Court for the District of Delaware signed an order enforcing the plan, which became effective May 27, 1947. (145a)

At the time the plan became effective, Cities had outstanding three separate classes of preferred and preference stock: (1) preferred stock, (2) preference B stock, and (3) preference BB stock.

The preferred class consisted of 560,600 shares of $6.00 cumulative preferred stock carrying an annual dividend of $6.00 and callable at Cities' option at any time at a price of $112.00 per share ($100.00 stated value plus $12.00 call premium) plus accumulated and unpaid dividends. As of May 27, 1947, each share of preferred was carrying $84.50 in accumulated and unpaid dividends. The redemption price for each share of preferred was thus $196.50 and the total redemption price for the 560,600 shares outstanding was $110,157,900. (145a, 146a)

The preference B class consisted of 86,000 shares of 60 cents cumulative no par stock carrying an annual dividend of 60 cents and callable at Cities' option at a price of $10.60 ($10.00 stated value plus 60 cents call premium) plus accumulated and unpaid dividends. As of May 27, 1947, each share of preference B stock was carrying $8.75 in accumulated but unpaid dividends. The redemption price for each share of preference B was thus $19.35 and the total redemption price for the 86,000 shares outstanding was $1,664,100. (146a)

The preference BB class consisted of 17,000 shares of $6.00 cumulative no par stock carrying an annual dividend of $6.00 and callable at Cities' option at a price of $106.00 ($100.00 stated value plus $6.00 call premium) plus accumulated and unpaid dividends. As of May 26, 1947, each share of preference BB stock was carrying $87.50 in accumulated

and unpaid dividends. The redemption price for each share of preference BB was thus $193.50 and the total redemption price for the 17,000 shares outstanding was $3,423,950. (146a)

Pursuant to the order of the Delaware District Court, Cities issued its 3% Thirty-Year Sinking Fund debentures in the aggregate amount of $115,246,950 in exchange for all its outstanding preferred, preference B and preference BB shares, all rights appertaining thereto, and all dividend arrearages thereon. (49a, 147a, 637a) The preferred and preference shares were cancelled upon the effective date of the order (32a).

Under the amended simplification plan, Cities was to call for redemption and retire through the use of treasury cash $40,578,100 principal amount of then outstanding 5% Convertible Debentures due in 1950 at the redemption price of 102. The balance of such 5% debentures then outstanding in the principal amount of $59,910,200 were to be retired with the proceeds to be derived from the sale of designated properties. Meanwhile they were to be senior to the new 3% debentures. (46a, 49a)

The Indenture under which the new 3% debentures were issued provided for an annual sinking fund of $1,500,000, which might be satisfied in cash or by delivery of debentures. (49a, 50a)

Cities agreed under the amended plan not to declare any cash dividends on its common stock except out of earned surplus accumulated subsequent to December 31, 1946. It also agreed to conditions upon which it could create or assume any funded indebtedness, issue stock, and mortgage or pledge securities; all for the protection of the new debenture holders. (50a)

The three classes of preferred and preference stocks involved herein were originally issued by Cities at various times in consideration for cash and properties having an aggregate fair market value at the time of issuance of no more than $45,323,846. (147a, 654a) At the time of the exchange in 1947 the aggregate fair market value of the preferred and preference shares was $80,313,600. (147a, 654a)

Cities had reacquired in the open market and by direct purchase from shareholders from 1932 to January 1, 1947, shares of its $6 cumulative preferred stock having a stated value of $60,033,124.36, at a cost of $29,083,575.69. (135a, 136a, 137a)

Cities had reacquired in the open market and by direct purchase from shareholders from 1932 to January 1, 1947 shares of its 60 cents cumulative preference B stock having a stated value of $2,870,002 at a cost of $2,251,725.76. (138a)

Cities had reacquired in the open market and by direct purchase from shareholders from 1932 to January 1, 1947 shares of its $6 cumulative preference BB stock having a stated value of $4,541,982.75, at a cost of $3,289,931.09. (139a)

The net effect of the exchange was adverse to Cities even though it enabled Cities to conform to and comply with the Public Utility Holding Company Act, got Cities the benefit of a tax deduction for interest payments, and the elimination of the preferred and preference shares permitted Cities to pay dividends to the common shareholders if money were available for that purpose. (641a) Cities exchanged its senior stocks, i.e., the preferred and preference shares, on which, except for one small payment, it had not paid a dividend since 1932, and on which under normal circumstances it would not be required to pay

dividends for the foreseeable future, for debentures, fixed and determinable debt obligations with mandatory annual, interest payments and mandatory sinking fund requirements. (641a, 642a)

Although Cities became entitled to a tax deduction for the interest payments on the debentures, it was henceforth required to pay such interest in addition to having to establish a sinking fund to redeem the debentures and abide by the restrictive covenants in the debenture issue. (642a)

Whereas with the preferred and preference shares outstanding, Cities had had the continuing business option to either pay out cash to its equity holders or use the funds to pay off debts or to expand its plant and equipment, the exchange resulted in a constant cash drain on the company of more than $3,600,000 annually. (201a, 642a)

The issuance of the debentures gave Cities an exceedingly high proportion of debt to equity capital at a time when experts believed this to be financially dangerous, and the indenture of the new debt burdened Cities with additional restrictions on its future debt financing based upon an earnings level ratio. (200a-205a, 642a)

Upon the issuance of the 3% debentures in the principal amount of $115,246,950, no value accrued to Cities in excess of the $45,323,846 originally received for the preferred and preference shares involved on account of (1) the stated call premium, (2) original discount on the preferred and preference stock when issued or (3) accumulated but undeclared dividend arrearages on the preferred and preference shares, which amounts constituted the difference between the aforesaid $45,323,846 and the principle amount of $115,246,950. (642a)

The stated call premium of $6,885,000 was merely a penalty payable on redemption and not value received by Cities. (238a, 642a)

The original discount in the amount of $13,366,154 incurred on preferred and preference shares when they were issued could not represent any value that could have accrued to Cities on the exchange in 1947. (237a, 643a)

The dividend arrearages of $49,671,950 did not constitute a binding legal obligation of Cities Service Company. (162a-165a, 242a, 643a) Upon analysis of investor behavior, Cities' financial condition, and the charter provisions relating to preferred and preference stocks, it became apparent that no value accrued to Cities on account of the cancellation of the arrearages of dividends. (643a, 644a)

Analysis of the market prices of the outstanding shares of the preferred and preference stocks shows that investors were not anticipating the payment of the arrearages of dividends. (243a, 644a)

Analysis of Cities' financial structure indicated that it was not possible for it to pay the arrearages of dividends on the preferred and preference stocks. (250a, 644a)

A study of Cities' annual earnings record, net income, accumulated arrearages, net income as a percentage of arrearages, after-tax interest coverage and a comparison of Cities' financial situation with three comparable independent groups of companies showed that Cities could not, should not or would not pay the accumulated dividend arrearages. (239a, 250a, 251a, 252a, 644a, 645a)

Comparisons as to interest coverage, rates of return on equity capital and on total capital, relative percentages of net income plus interest as percentages of total income, interest as a percentage of average debt capital, long term

capital as a percentage of total capital, and common and preferenced capital as a percentage of total capital, indicated a need for Cities to reduce debt charges and increase debt coverage. (259a-263a, 645a)

Comparison of Cities with comparable companies as to rate of return earned on average common and preferred capital and rate of return earned on average total capital showed that Cities' earnings were substandard. Net income as a percentage of total income, interest as a percentage of net income plus interest, and interest as a percentage of average debt capital when compared as between Cities and comparable companies indicated that Cities' relative net income was extremely low, or conversely, that its debt structure and interest charges were very high when compared to other competitive companies. (263a-270a, 645a, 646a)

Paralleling of capital structure ratios and the percentages of total capital represented by debt and equity evidenced the high debt or low equity level of Cities compared to the other companies. Cities' capital structure was several times heavier with debt than that of comparable companies while its equity as a percentage of total capital was much lower than that of comparable companies. (268a, 269a, 646a)

Cities' financial position was not strong enough to enable it either to pay the dividend arrearages or to issue debt obligations for them. The retirement and cancellation of the preferred and preference shares did not release to, or provide Cities with, any additional funds for the payment of its obligations or for dividends to common stockholders. Since the preferred and preference stocks disappeared upon the exchange no investment value accrued to Cities thereon. Cancellation of the preferred and preference stock converted into a firm, binding debt obligation

which must be paid at all events, a heretofore contingent claim relating only to relative priorities amongst shareholders in any distribution of earnings, which, if left to its own devices Cities most likely would have disposed of at little cost to itself. (646a)

An analysis of the effect of the issuance of the debentures on Cities' financial and economic structure showed that as a result of the exchange Cities overall financial condition had deteriorated. (380a, 384a, 647a)

Reference to (a) the economy of the United States during the period 1930 through 1947, inclusive; (b) the history of the public utility industry with particular emphasis on its experience under the Public Utility Holding Company Act of 1935; (c) the history of Cities with particular emphasis on the history and nature of its business, its experience under the Public Utility Holding Company Act of 1935; its operating results over the period of 1935 to 1946, inclusive; its capital structure from inception through May 27, 1947; and the trading activity in its various securities over the 1935-1947 period discloses that at all times pertinent to the period of investigation, analysis and study, the preferred and preference shares of Cities were speculative in nature. (87a-89a, 652a)

In general, the financial condition of Cities had improved over the period January 1935 to October 31, 1946. As a result of the effectuation of the simplification plan and the issuance of the 3% debentures, however, Cities became highly debt leveraged and its financial condition was not as strong thereafter in 1947. (376a, 384a, 647a, 652a)

From November 20, 1946, the date on which the original plan was proposed, the value of the preferred and preference shares to investors were totally dependent on the value of the consideration to be received in exchange for such shares, i.e., the 3% sinking fund debentures. (652a)

Evaluation of the Cities preferred and preference shares as of May 27, 1947, predicated on the plan of simplification, as amended, fails to reflect the true inherent worth of such shares in light of the fact that from November 20, 1946 to May 27, 1947 the value of these shares was totally dependent upon the value of the announced consideration to be received in exchange therefor, i.e., the new debentures. (652a)

The fair market value of Cities' preferred and preference shares, on their own merits as securities, without reference to any announced plan of simplification was $86,313,600 as of May 27, 1947. (652a)

The value to Cities Service Company of the preferred and preference shares received by it in exchange for the issue of its 3% Thirty-Year Sinking Fund Debentures on May 27, 1947, was $86,313,600. (654a)

The exchange of 3% debentures for all of the outstanding preferred and preference shares did not constitute a redemption of such shares. (151a-157a, 162a)

The exchange of the 3%, Thirty-Year Sinking Fund Debentures for the preferred and preference shares by Cities was not a unilateral or voluntary one. (47a, 151a, 153a)

The principal amount of the 3%, Thirty-Year Sinking Fund Debentures exceeded both the amount received by Cities for the preferred and preference shares when issued and the value of such shares either to investors or to Cities, at the time of the exchange in 1947. (Record)

Pursuant to the sinking fund provisions of the indenture, Cities purchased $1,519,500 principal amount of the 3% debentures in 1953 at an aggregate cost of $1,398,357.39. In 1954 Cities purchased $1,805,900 principal amount of 3% debentures at an aggregate cost of $1,786,569.02. (147a)

Summary of Argument

For its taxable years 1953 and 1954 Cities Service Company is entitled to loss deductions under Section 165 of the Internal Revenue Code of 1954 because of the premature retirement of some of its 3% Thirty-Year Sinking Fund Debentures in such years, or, in the alternative, Cities is entitled to deductions for 1953 and 1954 pursuant to Section 163 of the Code for amortization of debt discount on its outstanding 3% Thirty-Year Sinking Fund Debentures plus the unamortized and undeducted debt discount on the 3% Debentures prematurely retired in such year.

The amount of such loss or debt discount is to be measured by the difference between the amount received for such 3% Thirty-Year Sinking Fund Debentures and either their repurchase price in 1953 and 1954 (loss deduction) or the principal amount of such Debentures (debt discount amortization deduction).

The amount received by Cities Service for the 3% Thirty-Year Sinking Fund Debentures is, as a matter of law and fact, $45,323,846, the amount originally received by Cities for the preferred and preference stocks which in May, 1947 were changed into the 3% Thirty-Year Sinking Fund Debentures, or alternatively, as the Court below found on the basis of the record, $86,313,600, the fair market value and the "value to Cities" of the preferred and preference shares at the time of the change.

The recent decision by the United States Supreme Court in the case of *Commissioner* v. *National Alfalfa Dehydrating and Milling Co.*, —— U.S. ——, 42 U.S.L.W. 4798 (May 28, 1974), which involved only the deduction of debt discount amortization, does not prohibit or prevent the deductions claimed by Cities Service Company but instead

supports Cities' contentions that it is entitled to the deductions based, at the very minimum, on the $86,313,600 market value of the preferred and preference stocks or most probably on the $45,323,846 received when such stocks were originally issued. The Supreme Court most certainly did ***not*** hold that debt discount may not exist when a corporation exchanges its debt securities for its own preferred stock. The decision merely established a standard of proof of such existence. The record in the case at bar more than adequately meets all of the requirements of that standard.

The Government's contention that the *National Alfalfa* case requires reversal of the decision of the Court below is highly presumptuous and gives such case an interpretation or application that the Supreme Court itself refused to recognize or apply. Likewise, the Government's contention that the amount received by Cities Service Company for its 3% Thirty-Year Sinking Fund Debentures was equal to their principal or face amount is fallacious and contrary to the findings and opinion of the Securities and Exchange Commission which authorized and supervised the exchange, contrary to the evidence of record and findings of the Court below on two separate occasions, and erroneous as a matter of both fact and law.

ARGUMENT

A. In Support of the Appeal of Cities Service Company

I. The Court Below Erred In Not Holding That The Amount Received By Cities Service Company For Its 3%, Thirty-Year Sinking Fund Debentures Was $45,323,846.

It remains undisputed and uncontroverted that when Cities Service Company, pursuant to the findings and orders of the Securities and Exchange Commission, issued its 3% debentures for its outstanding preferred and preference shares, the only amount or value it had received was the $45,323,846 originally paid in when the preferred and preference shares were issued. The exchange itself in 1947 was merely an exchange of paper which by converting the stock to debt, obligated Cities unconditionally to repay the $45,323,846 originally paid into it plus an additional $69,923,104, although the conversion itself at that moment added nothing to and subtracted nothing from its assets. Cf. *Union Pacific R.R. Co.* v. *United States* (Ct.Cls. 1968), 401 F.2d 778, *cert. denied,* 395 U.S. 944 (1969); *Erie Lackawanna R.R. Co.* v. *United States* (Ct.Cls. 1970), 422 F.2d 425. The reduction in assets would inevitably occur upon payment of the debentures at or before maturity. The amount paid in for the preferred and preference shares became the "basis", so to speak, for the 3% debentures as far as the Company was concerned, as this amount became the consideration for the debentures.

In the Court below, on defendant's first motion for summary judgment, Judge Mansfield held that the $45,323,846 was the "floor" for determining the amount received by Cities and he remanded the case for trial on the narrow issue of whether that "floor" or some higher value accrued to Cities because of the exchange. At the trial Cities

introduced an overwhelming abundance of testimony and documentary evidence proving conclusively that upon the exchange in 1947 Cities not only received no value in excess of the amount originally paid in for the preferred but actually suffered an over-all additional financial detriment because of the exchange. The trier of the facts, Judge Tenney, accepted the evidence adduced by Cities, found all of the facts necessary to support Cities' contention, and rejected all evidence adduced by the Government as unacceptable, "based upon false premises" that "cannot withstand analysis." (648a) Upon reviewing the applicable law and pertinent cases, however, he concluded that despite the strong proof in the record that Cities received nothing in excess of the $45,323,846 for the debentures he felt constrained to hold that, as a matter of law (654a) the value to Cities must be deemed to be the "conceded" aggregate fair market value of the preferred and preference shares on May 27, 1947, the effective day of the exchange, i.e., $86,313,600.

Cities is aware that since Judge Tenney entered his opinion and judgment, the authority upon which he relied in support of his *conclusion of law* that the fair market value of the preferred and preference shares was the controlling amount may have been eroded. Judge Tenney relied primarily upon the opinion of the Court of Appeals for the Tenth Circuit in *National Alfalfa Dehydrating and Milling Co.* v. *Commissioner* (CA 10th, 1973), 472 F.2d 796, a case involving debt discount. This opinion subsequently has been reviewed and reversed by the United States Supreme Court. (The thrust of that reversal will be discussed in more detail in subsequent portions of this brief.) At this point it is sufficient to say that there has been doubt cast upon the soundness of the proposition that *fair market value* is a relevant factor where, as in the

instant case, a corporation exchanges its bonds for its own stock and the amount originally paid in for the stock is *less* than the principal amount of the bonds exchanged therefor. Cities Service Company submits that in such context the amount paid in for the stock must be compared with the principal amount of the bonds and *hypothetical* market values are of no consequence. This contention is even more valid in the instant case where the evidence shows conclusively, and the Court below found, that Cities acquired no value on the exchange in excess of the amount originally paid in for the preferred and preference shares.

The Supreme Court in *Commissioner* v. *National Alfalfa Dehydrating and Milling Co.,* —— U.S. —— (May 28, 1974) 42 U.S.L.W. 4798, strongly indicated that where a corporation exchanges its debt obligations for its own preferred stock, the market value of the preferred is irrelevant and the pertinent factors determining the effect of the transaction on the corporation are the amount originally received for the preferred compared to the principal amount of the debt obligations. If the amounts are the same the corporation has not been adversely effected because:

> "The cost of the capital invested in the corporation was the same whether represented by the preferred or by the debentures, and was totally unaffected by the market value of the shares received at the time of the issuance of the debentures. * * * (T)he substitution by N.A.D. of its debentures for its previously outstanding preferred, without more, did not create an obligation to pay in excess of an amount previously committed, or established the base upon which debt discount can arise." (42 U.S.L.W. 4804)

In the instant case, Cities most certainly incurred "an obligation to pay in excess of an amount previously committed." Because of the compulsion of the Securities and Exchange Commission, and following extensive financial investigation and analysis of its securities, and public, adversary hearings, Cities became obligated to pay in thirty years $115,246,950 for which it had received only $45,323,846. Clearly, this is a "base" upon which debt discount (or loss in the instant case) could and did arise.

The Government in attempting to refute this verity alleges that prior to May 27, 1947, Cities was already obligated to *pay* an amount equal to the principal amount of the debentures. This could be true only if the arrearages of dividends, plus the call premium, plus the stated value of the preferred and preference shares constituted a matured, binding, legal obligation of the Company. Judge Mansfield held that this was not so, the Securities and Exchange Commission held that this was not so, and the District Court for Delaware said it was not so. There is no rule of statutory or case law that holds dividend arrearages and/or call premiums are a binding debt obligation, absent either a dividend declaration or a redemption. Judge Mansfield held that no redemption occurred here, the Securities and Exchange Commission held that no redemption occurred and Cities certainly did not declare a dividend. Except in this litigation, no Government Agency, including the Internal Revenue Service, has ever contended that the exchange constituted a redemption of the preferred and preference shares. The exchange, carried out under the compulsion of the Public Utility Holding Company Act was not a voluntary one on the part of Cities. It is extremely doubtful, if not impossible, that a third party can order a redemption of corporate stock. In any event, as a matter of fact, it was the view of the SEC and the financial experts that Cities was financially unable to redeem these shares, and it is clear that no redemption took place.

As the Supreme Court reiterated in *Commissioner* v. *National Alfalfa, supra,* "a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred." 42 U.S.L.W. 4802. No redemption occurred here so one cannot be imputed.

On this basis, therefore, the Court below should have held that the amount received by Cities for the debentures was the amount paid in for the preferred and preference shares. This would substantially accord with the opinion of the United States Tax Court, which originally decided the *National Alfalfa* case. See *National Alfalfa Dehydrating and Milling Co.* v. *Commissioner,* 57 T.C. 46 (1971).

II. Alternatively, The Court Below Properly Held That The Amount Received By Cities Service Company For Its 3%, 30 Year Debentures Was $86,313,600.

The uncontested and ultimately "conceded" fact is that when Cities Service Company exchanged its 3%, 30 year debentures for its outstanding preferred and preference shares, the fair market value of the preferred and preference shares was $86,313,600. The Court below held that such fair market value constituted the "value to plaintiff" of the preferred and preference shares and, hence, the amount received by Cities for its 3% debentures. This valuation was arrived at after consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion. This consideration also encompassed both the market prices of the stocks and the market prices of the to-be-issued debentures, the latter prices being reflected in the prices of the preferred and preference shares after the plan of simplification became known to the public.

The Government contends that in the recent case of *Commissioner* v. *National Alfalfa Dehydrating and Milling Co., supra,* the Supreme Court held that as a matter of law market value is not a relevant or valid factor when a corporation exchanges its debt obligations for its own stock. Cities submits that is an incorrect interpretation of the opinion in that case, which actually was decided on inadequacy of proof.

As previously mentioned herein, *National Alfalfa* involved a transaction where in 1957 a corporate taxpayer (NAD) exchanged its $50 face value, 5% sinking fund debentures for its outstanding, unlisted $50 par value 5% cumulative, sinking fund, preferred shares. The shares were quoted on the over-the-counter market at $33 per share but there was no record of any specific sales. Based upon the difference between the face value of the debentures and the quoted $33 per share, the taxpayer claimed interest deductions under Section 163(a) of the Revenue Code on the ground that such difference constituted original issue discount amortizable over the life of the debentures. The Supreme Court, pointing out that historically original issue discount served the same function as stated interest in that it is simply compensation for the use or forbearance of money, also observed that the Court has often recognized the economic function of discount as interest. The Court noted that Section 1232(b) of the Internal Revenue Code of 1954, which constituted the first statutory recognition of bond discount, provides that "the term original issue discount means the difference between the issue price and the stated redemption price at maturity" and that in 1969 the Section was amended to provide that:

> **"In the case of a bond or other evidence of indebtedness * * * which is issued for property and which**
>
> **(A) is part of an issue a portion of which is traded on an established securities market, or**

(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such bond or other evidence of indebtedness * * * shall be the fair market value of such property." (42 U.S.L.W. 4801, footnote 8)

The Court of Appeals for the Tenth Circuit, in holding for the taxpayer, had applied what it termed the "economic realities" test, which treated the transaction as though NAD had issued its $50 debenture for $33 and then used that cash to purchase the preferred. The Supreme Court pointed out, however, that acceptance of such a test requires the rejection of the established tax principle that a transaction be given its tax effect in accord with what actually occurred and not in accord with what might have occurred, and would also require the Court to speculate about the market price and value to the corporation of the debentures had they been sold upon the open market—two steps the Court was reluctant to take.

Although admitting that the aforementioned 1969 amendment to Section 1232 did not apply to that particular case, the Supreme Court apparently sought to draw a parallel between the provisions of the 1969 amendment and the rule to be applied to NAD. It held that in the absence of any actual or even attempted sales of the debentures *or* purchases of the preferred by NAD, the Court would not speculate as to what the market price and investor reaction to such events would have been for three reasons:

First, there was nothing in the record to establish the price at which the debentures could have been sold.

Second, there was nothing in the record to indicate that NAD would have been able to purchase all of its outstanding preferred on the open market, or at what price that quantity of stock would have been purchased in the light of the impending exchange. (The over-the-counter quotations were deemed a "thin market" hardly representative of the entire 47,059 preferred shares outstanding).

Third, when a corporation issues its debt obligations in exchange for outstanding preferred the claimed fair market value of both securities is somewhat artificial as the exchange is insulated from market forces.

With regard to the "market forces" or the "competitive money market" which the Court deemed necessary to establish the concept of debt discount, it went on to hold that as a substitute for market forces it would be necessary to consider the fair market value of the bonds, the financial condition of NAD at the time of the exchange, including both its credit position and its profits prospects, and the availability and cost of capital in the general market as well as from preferred shareholders.

Cities Service Company submits that the opinion of the Supreme Court in *National Alfalfa* does not prohibit the affirmance of the judgment of the Court below to the extent that it held that the amount received by Cities for its 3% debentures was the fair market value of the preferred and preference shares, for two reasons:

1. As will be discussed in more detail, *infra,* Cities bases its claim for deductions primarily on Section bases its claim for deductions primarily on Section 165 of the Revenue Code, which is concerned with losses, and not solely on the concept of original issue discount which must qualify as interest to be deductible under Section 163 of the Revenue Code.

2. The unrefuted evidence in the record conforms with all of the requirements for a competitive market or a "market substitute" as outlined by the Supreme Court in *National Alfalfa.*

The exchange here involved was hardly a transaction insulated from the competitive money market. The preferred and preference shares were widely held and were actively being traded on the Boston Stock Exchange and the New York Curb Exchange. The Securities and Exchange Commission held extensive public hearings at which the holders of the preferred and preference shares were well represented. The exchange of the 3% debentures for the shares was consummated only after intensive scrutiny and evaluation of Cities financial structure, future prospects for profit, and operating efficiency. Thus, the exchange, as imposed and supervised by the SEC was, in effect, *subject* to the competitive market.

In determining the fair market value of the preferred and preference shares the expert witness relied upon by the Court below took into consideration:

(1) the general economic and market conditions of the country at the time of the exchange and prior thereto,

(2) the economic situation of the utility industry at the time,

(3) the history and nature of the business of Cities Service Company; its economic background and its financial condition at the time of the exchange; its capital structure, including debt and equity; its operating results for a ten year period; its income history, growth rate and profit expectations; the availability of capital both debt and equity; the effect of the exchange on investor behavior, on the market prices of the shares, and with regard to the debentures; and, in general, all of the factors deemed necessary by the Supreme Court to establish an accurate valuation.

Cities Service Company submits that the *National Alfalfa* decision stands for the proposition that NAD failed to carry its burden of proof in circumstances where proof of the claimed values was extremely difficult if not impossible. Not so in the instant case, where the evidence overwhelmingly proves the values claimed by Cities.

III. The Court Below Erred In Not Holding That Cities Service Company Incurred A Deductible Loss Upon The Retirement Of Some Of Its 3%, Thirty-Year Sinking Fund Debentures In 1953 and 1954.

Cities Service Company's primary contention in this case is that the difference between the amount received by it for its 3%, 30-year debentures and the amount paid to retire some of them in 1953 and 1954 is deductible as a loss under Section 165 of the Internal Revenue Code (13a, 141a, 637a). Such section, like its predecessor in the 1939 Code, Section 23(f), provides that:

> "there shall be allowed as deductions all losses incurred in the taxable year."

When Cities issued the preferred and preference shares it received $45,323,846. On May 27, 1947, it exchanged $115,246,950 principal amount of its 3% debentures for such shares. The latter transaction had no immediate independent financial significance in that it resulted in no immediate loss. See *Union Pacific R.R. Co.* v. *United States* (Ct. Cls. 1968) 401 F.2d 778. In 1953, in anticipation of sinking fund requirements Cities retired some of these debentures, paying therefor $1,398,357.39, for which it had originally received $616,779.28. In 1954, in anticipation of sinking fund requirements Cities retired additional 3% debentures, paying therefor $1,786,569.02, whereas it had originally received $732,794.03 when the shares were issued.

Cities submits that the differences between what it received when the shares were issued and what it paid when

the debentures were retired, i.e., $781,778.11 in 1953 and $1,053,774.99 in 1954, constitute deductible losses without reference to "original issue discount", "interest", or similar concepts. In the alternative, Cities claims that if the amount deemed received for the 3% debentures is $86,-313,600 (the fair market value of the preferred and preference shares), the differences between the purchase price of the debentures and the proportionate amount of such fair market value attributable to the bonds retired, i.e., $381,478.38 in 1953 and $453,380.59 in 1954, are deductible as losses. The law so provides and has so provided for many years. Whether the entire loss may or may not be amortized over the term of the debentures or only recognized at retirement of the debentures, has no bearing upon the classification of the deduction as a "loss from the funding operation." See, *Helvering* v. *Union Pacific R.R. Co.*, 293 U.S. 282 at 286 (1934).

When a corporation issues its bonds and later repurchases them for *less* than the amount originally received for them, the sum thus saved is deemed to be taxable income. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931). By the same token if the corporation purchases the bonds for *more* than was received for them, the difference is deductible loss or expense. Cf. *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926). In *Commissioner* v. *Rail Joint Co.*, (CA 2nd, 1932) 61 F.2d 751, this Court recognized the rule to be that "* * * the consideration received for the obligation evidenced by the bond as well as the consideration paid to satisfy that obligation must be looked to in order to determine whether gain or loss is realized when the transaction is closed; i.e., when the bond is retired." See, *Fashion Park, Inc.* v. *Commissioner*, 21 T.C. 600 (1954) which also accepts this concept and in which debentures were issued in exchange for stock of the issuing

corporation. See also, *Burnet* v. *Logan,* 283 U.S. 404 (1931). It was upon the retirement of the debentures that Cities was able to determine the exact amount of the loss so as to justify its deduction at that time. *Lucas* v. *American Code Co.*, 280 U.S. 445 (1930).

Contrary to any inference of Judge Tenney in the Court below, Cities at trial did not abandon either its theory that it was entitled to a loss deduction under Section 165 or to a discount deduction under Section 163 of the Code. The sole issue to be determined by the Trial Court was the "value to plaintiff of the preferred and preference shares received by it in exchange for the issuance of its 3% Thirty Year Sinking Fund Debentures on May 27, 1947" (173a). In a prior opinion in this case, Judge Mansfield held that where a true loss has been sustained by the taxpayer "the debt discount concept, which is at best a more or less arbitrary creation, will not be construed in a technical manner to bar the taxpayer from *deducting the loss as discount*" (159a) (emphasis supplied). See, *Erie Lackawanna R.R. Co.* v. *United States*, (Ct. Cls. 1970) 422 F.2d 425 at 427, footnote 7.

Because of the circumstances under which the question arose and the nature of the issue as presented to them, the Courts have been little concerned with whether the claimed deduction was termed "discount" or "loss", as the ultimate tax effect was usually the same. Also the taxpayers who have litigated the question have generally done so on the basis of the "discount" theory for either of two reasons:

1. No bonds were retired in the year in which the deduction was taken so the claimed deduction, of necessity, had to be limited to an amortization deduction which is identical to the discount deduction, and/or;

2. The amount originally received for the stock or securities exchanged for the debt obligation was identical with, or greater than, the principal amount of the debt obligation. Accordingly, no "loss" could have been incurred and no deduction claimed under Section 165.

The latter reason is undoubtedly why NAD in the *National Alfalfa* case confined its contention to a claim to a deduction for original issue discount under Section 163. It is noteworthy at this point to observe that in the *Erie Lackawanna* case, *supra,* it was the Government which contended that the deduction must qualify as a loss under Section 165 of the Code. See 422 F.2d 425 at 427, footnote 7, citing, *Dodge Bros.* v. *United States,* (CA 4th, 1941) 118 F.2d 95.

Cities submits that most if not all of the discussion in the *National Alfalfa* case is applicable only to the nature, existence and deductibility of original issue discount (which must qualify as "interest" under Section 163 to be deductible) and has no pertinence where a loss is involved and a deduction claimed therefor pursuant to Section 165, or even as an ordinary and necessary business expense under Section 162 of the Code. See, *Scherman* v. *Helvering,* (CA 2nd, 1935) 74 F.2d 742; *Helvering* v. *Community Bond & Mortgage Corp.,* (CA 2nd, 1935) 74 F.2d 727; *Five Star Mfg. Co.* v. *Commissioner,* (CA 5th, 1966) 355 F.2d 724.

IV. ALTERNATIVELY, The Court Below Properly Held That Cities Service Company Incurred Amortizable Debt Discount Upon The Exchange Of Its 3%, Thirty-Year Sinking Fund Debentures For Its Preferred And Preference Shares.

The Court below held that the "issue price" of Cities 3% Debentures was the fair market value of the preferred and preference shares exchanged for them and that such

fair market value was $86,313,600. Cities Service Company alternatively submits that, regardless of whether the amount received for the debentures was $86,313,000 or $45,323,846, the difference between the amount received for the debentures (their "issue price") and the principal amount thereof constitutes a cost or expense to Cities of acquiring and/or retaining the use of capital. *Helvering* v. *Union Pacific R.R. Co., supra.* As such it may be amortized and deducted as debt discount over the term of the bonds with adjustments for premature retirements.

While all tax deductions involving debt need not qualify as interest, it is apparent that in the view of the Supreme Court decision in the *National Alfalfa* case, amortizable debt discount deductions must qualify as interest in order to be deductible. It should be carefully noted here that in *National Alfalfa* no deduction other than an interest deduction could be claimed because the principal amount of the debt equaled the amount originally received for the preferred, and dividend arrearages were satisfied by the issuance of common stock warrants. 42 U.S.L. 4799. In the instant case, however, the facts show clearly that discount expense actually was incurred within the purview of Section 23(b) of the Internal Revenue Code of 1939, Sections 61(a) and 163(a) of the Internal Revenue Code of 1954 and applicable Treasury Regulations. The preferred and preference shares carried a stated 6% dividend rate which, when calculated on the amount actually paid in for the preferred and preference shares makes the actual rate of return higher than 6%. For some fourteen years the dividends had not been paid. After extensive consideration the SEC ordered the Company to unconditionally obligate itself to ultimately pay out $115,246,950, whereas it had only received $45,323,846. The Government admits that the Securities and Exchange Commission itself found that there was little likelihood that Cities could pay the

arrearages in cash. Expert testimony at the trial in the Court below demonstrated conclusively that Cities, from an economic and financial standpoint, could not and should not have issued the debentures under the conditions that it did. Certainly such a payment gives rise to discount within the definition of "a cost of retaining capital". Cities did not voluntarily agree to make the payment; it was obliged to do so to comply with the Holding Company Act, and by the adversary action of the Securities and Exchange Commission and the preferred and preference shareholders, with the result that the preferred and preference shares were converted into a large debt obligation with mandatory interest payments and sinking fund requirements and which was payable, in all events, within thirty years. This exchange bore no resemblance to the completely voluntary exchange in *National Alfalfa* in which there were no hearings, no compulsion and only an intra-corporate agreement.

The Court below was presented with and accepted as valid the extensive proof that the fair market value of the preferred and preference shares was $86,313,600, which amount constitutes a combination of the fair market value of the shares alone and an incremental element due to the effect on the market of the anticipated mandatory disposition of the claims of such shares. (Note that even when the Plan was announced to the public the average of the preferred and preference market prices increased only to approximately $87,500,000) (653a).

Cities submits that the record in this case more than conforms to the criteria established by the Supreme Court in *National Alfalfa* for determining the true existence and amount of debt discount by reference to the fair market value of the stock exchanged for the debt. (See, Argument, Section II, *supra*, which is incorporated herein by this reference).

In any event, prior to the intervention of the Securities and Exchange Commission, Cities was rapidly acquiring large amounts of its preferred and preference shares at deep price reductions, the average cost being about half of the stated value. The SEC intervened through the medium of the Public Utility Holding Company Act of 1935 and Cities purchases were restricted to no more than $50,000 worth per year. Thereafter, the fair market value of the preferred rose to $86,313,600, thus reflecting the market appraisal of Cities ability to eliminate the preferred and preference shares and the arrearages thereon, including the market quality of any alternative disposal program whether by cash payment or debt obligation. In short, the sophisticated market judged Cities financial ability to eliminate the preferred and preference shares at $86,313,600. This "fair market value" is thus a fair reflection of the to-be-issued 3% debentures. *United States* v. *Davis*, 370 U.S. 65 (1962). Surely, the difference between that amount and the principal amount of the debentures constitutes additional interest for disposing of the preferred and preference shares by the use of debt obligations. See, *Industrial Development Co.* v. *United States*, (D.C. Ill. 1956) 138 F. Supp. 63.

The preferred and preference shareholder could have disposed of their interests for $86,313,600 in cash on the market and Cities could have acquired the shares for that amount if it had the money. Instead, the preferred and preference shareholders became the financing agents. As this Court so aptly held in *Nassau Lens Co.* v. *Commissioner*, (CA 2d, 1962) 308 F.2d 39, when the seller also becomes the financing medium by taking a note, bond or debenture instead of cash, the tax laws *will* recognize a charge for the use of such money.

Instead of $86,313,600 in cash, the "seller", through the agency of the SEC, was required to take debentures but in larger principal amounts than the value of the preferred and preference shares. The difference between the principal amount of such debentures and the fair market value of the preferred and preference shares is the additional interest exacted because of the financing medium.

The situation involved in this case is not the type the Supreme Court indicated wariness of in *National Alfalfa*. There the Court indicated that extreme caution should be exercised in determining debt discount by reference to fair market values when a corporation is dealing in its own securities because the transaction is usually somewhat artificial and not subject to the scrutiny of the public market. By this the Court obviously meant that fair market values are irrelevant when a corporation is engaged in a *private* transaction between itself and consenting shareholders and there is no active public trading. Not so in the instant case.

There was no inside transaction here. The entire transaction was instigated, investigated, perpetuated and consummated by the Securities and Exchange Commission. There was advocacy on all sides and the resolution of the dispute was arrived at after an extensive adversary proceeding. Clearly this was not a private transaction. Cities did not willingly exchange its debentures for the preferred and preference shares. It did not willingly agree to pay amounts which, but for the SEC, it would never have paid. Such excess price has to be the cost of obtaining and keeping its capital intact.

The Government makes much of the arrearages of dividends and argues vehemently that the exchange "masked a * * * dividend" to the preferred and preference shareholders. (Gov't Brief, p. 13, footnote*). Of course this

ignores the fact that the preferred and preference shares were cancelled upon the exchange. A dividend cannot be paid to non-stockholders! Further, it is well established that a dividend cannot be declared for a corporation—it must be declared by it. The SEC cannot be held to have declared a dividend for Cities. The argument also blithely assumes that a promise to pay a sum certain in thirty years is the absolute equivalent of cash received today. This is positively economically untenable.

Cities submits that the record adequately supports a determination and finding of true amortizable debt discount measured by the difference between the principal amount of the 3% debentures and either $86,313,600 or $45,323,846.

V. The Court Below Erred In Computing The Judgement For 1953 And 1954 By Excluding Prior Years Amortization Deductions Allowable But Not Deducted.

Regardless of whether the amount received by Cities Service Company upon the issuance of its 3%, 30 year debentures was $45,323,846 or $86,313,600 and regardless of whether the difference between the principal amount of the debentures is *amortizable* as loss or discount (but absolutely if the deduction is a *non-amortizable loss*) Cities submits that the Court below erred in reducing the deduction for 1953 and 1954 by any amount attributable to the debentures retired in those years that could have been amortized and deducted in the years 1947 through 1952.

The basis of the judgment computation is that the total loss or discount is to be amortized over the term of the debentures in equal amounts, with the amortization deduction for the years 1953 and 1954 increased by any unamortized loss or discount not yet recovered on the debentures retired in those years. In making the latter increase, the

Court below excluded from the increase any amounts that could have been but were not amortized in prior years.

The Treasury Regulations applicable to 1954 specifically provide that:

> "* * * if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of discount *deducted* prior to repurchase, or * * * minus any amount of premium already *returned as income* prior to repurchase, the excess of the purchase price over the issue price adjusted for *amortized* premium or discount is a deductible expense for the taxable year." Treasury Regulations, Section 1.163-3(c)(1) 1954. (emphasis supplied)

> Also:

> "If bonds are issued by a corporation and are subsequently repurchased by the corporation at a price which is exceeded by the issue price plus any amount of discount *already deducted,* or * * * minus any amount of premium already *returned as income,* the amount of such excess is income for the taxable year." Treasury Regulations, Section 1.61-12(c)(3) 1954 (emphasis supplied)

Treasury Regulations applicable to 1953 are substantially similar. Cities submits that the clear implication of the Regulations is that the possible or anticipated loss, expense, income or gain may be amortized over the term of the debt in expectation of its occurrence so as to reflect income or loss as clearly as possible on an annual basis. See, *Helvering* v. *Union Pacific R.R. Co., supra.* However, when the bonds are retired and the actual amount of income or loss is known, such actual amount, less any amount actually *included* as income or *deducted* as expense in prior

years, must be deducted or included in the year of retirement. If this is not so then the thrust of the Regulations must be that if an expense or loss is suffered then the "allowed or allowable" limitation is applied to limit the deduction, *but* if a premium is involved only the amount of income or gain actually reported on the returns for prior years may be *excluded* from the retirement years' income. Cities does not believe that it was intended that the Treasury Regulations be applied in such a discriminatory manner.

B. Answer to the Appellate Brief of the United States

In its brief in support of its appeal, the United States predicates its case upon three points or arguments. In answering these arguments, Cities will address each Point separately although in some respects they overlap or are repetitious.

Point I

The first point contended for by the Government is that the United States Supreme Court in the case of *Commissioner* v. *National Alfalfa Dehydrating and Milling Co.,* 42 U.S.L.W. 4798, held that no bond discount may ensue on the exchange of taxpayer's debentures for a taxpayer's own outstanding preferred stock. The Government also implies in its brief that *National Alfalfa* stands for the proposition that debt discount cannot ensue unless the debt is issued solely for cash.

Cities submits that these allegations regarding the scope and thrust of the *National Alfalfa* case are erroneous and the basis for the Government's contentions are merely words and phrases from the Supreme Court's opinion in that case taken out of their context. Actually, the thrust

of the opinion in that case is to the contrary. In *National Alfalfa,* debentures with a principal amount of $50 were issued in exchange for preferred shares for which the taxpayer, NAD, had *originally received* $50; the dividend arrears were separately satisfied by the issuance of *common stock warrants* to the preferred shareholders, and the 5% interest rate on the debentures was the same as the dividend rate on the preferred. Both securities carried sinking fund provisions. Th *alleged* market value of the preferred was $33 per share and little, if any, trading of such shares took place. The Supreme Court merely pointed out, or catalogued, the formidable and intricate burden of the proof to be sustained in such circumstances in order to support a claim for a deduction for bond discount based upon alleged fair market value, concluding that where the amount to be repaid pursuant to the debt instrument is the same as the amount originally received by the corporation upon the issuance of the preferred, the market value of the preferred, *without more,* does not establish the base upon which debt discount can arise.

Contrast that situation to the one in the instant case. Here, Cities received $45,323,846 when it issued the preferred and preference shares, which had a par or stated value of $58,690,000. The dividend rate on the preferred and preference shares was 6%. There was no sinking fund. Except for one small payment, dividends had not been paid in 14 years. Other than the contingent right to cumulative dividends, to a call premium and ineffective voting rights, the preferred and preference stocks were without real power, rights or special protective covenants. Even though the stockholders wanted full cash payment the Securities and Exchange Commission, recognizing that such payment could not be made, required Cities to exchange 3% sinking fund debentures totalling $115,246,950

for such shares. Surely this constitutes more than the mere "substitution" "restructuring" or "alteration in the corporation's capital structure" which the Government contends took place. Surely the difference in obligations, both in kind and in amount, is material and the exchange did much more than "rearrange the liabilities column". Cities, because of the exchange became obligated to pay out $115,246,950 for which it had received only $45,323,846. The difference, it is submitted, constitutes an additional cost of the continued use of the capital which it obtained when the preferred and preference shares were issued and which was retained until the 3% debentures were retired. Even if the Government is correct as to only *cash* transactions giving rise to discount, $45,323,846 is the only *cash* Cities ever received in the transactions.

Point II

The basic premise of the argument under Point II of the Government's Brief, as under Point I, is the conclusion that no bond discount may ensue on the exchange of bonds for outstanding stock. After reviewing many of the cases in which discount was claimed upon the issuance of debt the Government draws the conclusion therefrom that the decision in the *National Alfalfa* case precludes the recognition of either discount *or* loss when debt is issued for stock* because the Supreme Court in *National Alfalfa*

* Parenthetically, it should be noted here that, as the Government admits in its Brief, the "loss" cases, which were decided in the Court of Claims, were the very cases which were deemed to be in conflict with the decision of the Court of Appeals for the Tenth Circuit in *National Alfalfa*, thus justifying *certiorari* by the Supreme Court which *reversed* the Tenth Circuit. Cities has always contended that the instant case meets all of the criteria established by the Court of Claims for the recognition of loss or discount in *Erie Lackawanna R.R. Co.* v. *United States* (Ct.Cl., 1970) 422 F.2d 425, and *Missouri Pacific R.R. Co.* v. *United States* (Ct.Cl., 1970) 427 F.2d 727, modified, 433 F.2d 1324, *cert. denied* 402 U.S. 944 (1971) and submits that, in effect, the Supreme Court approved the opinion of Judge Mansfield in the Court below.

adopted a test similar to that adopted by the Court of Appeals for the Fifth Circuit in *Claussen's, Inc.* v. *United States* (CA 5th 1972) 469 F.2d 340, which allegedly had held that new capital must be procured on the exchange in order for discount to be recognized in a situation where the stockholders retained their stock interests and received the debentures as a dividend.

Cities submits that the Government's reference *dictum* in to the *Claussen's, Inc.* case is highly inappropriate here, especially as that case is completely distinguishable from the instant case in all pertinent respects. There, the bonds were issued as *dividends,* without an iota of consideration, to the common stockholders who also retained their equity interests in the corporation. Analogizing the instant case to cases where *dividends* were issued to common stockholders, the Government then argues that the dividend rule must be applied here, because the bonds were exchanged for preferred and preference shares which were "substantially equal to the preferred stock received" (Gov't Brief p. 14) and as no new capital was obtained by the issuance of the debentures, bond discount cannot arise.

But this is not the law! The Government's own quotation from the *Claussen's, Inc.* case reveals its inapplicability here. (See Gov't. Brief, pp. 11-12). In distinguishing the dividend situation the Court of Appeals for the Fifth Circuit pointed out in *Claussen's Inc.* that "bond discount should arise only where the *use* of capital is actually procured by a bond issue" or as the Supreme Court stated in *National Alfala,* "additional cost for the use of capital" is incurred. (42 U.S.L.W. at 4903; Gov't Brief, p. 13). Here it cost Cities an additional $69,923,104 to keep, for an additional 30 years, the $45,323,846 it had received upon the issuance of the preferred and preference shares. The 3% debentures here were not issued as a dividend. They were

issued in an *exchange* (or sale or conversion) for the preferred and preference shares. The Securities and Exchange Commission so held when considering the simplification plan as did the Court below in this litigation. This Honorable Court has clearly pointed out the difference between a dividend and a sale or exchange in *Himmel* v. *Commissioner* (CA 2d, 1964) 338 F.2d 815.

It has never been contended here that there was any identity of interest or ownership between preferred and preference shareholders and the common shareholders and, in fact, there was none. Such inference or implication by the Government is not justified. The preferred and preference shares and the common stocks of Cities were publicly traded and their interests were separately represented before the Securities and Exchange Commission. The insinuations in the Government's Brief (p. 13) regarding "a cover for the declaration of a dividend", "a gift by Cities Service to its preferred shareholders", and "masked a $19,569,535 dividend to the preferred shareholders", as well as the quotation from *National Alfalfa* regarding the *Claussen's, Inc.* case, is highly misleading and unfair as the Government well knows that no dividend or gift was involved here, whereas in *Claussen's Inc.* the bonds were distributed without consideration to the common stockholders. Here the entire stock interests of the preferred and preference shareholders terminated upon the exchange. The very quotation from *National Alfalfa* in the Government's Brief (pp. 13, 14) clearly points out the speciousness of its argument. In distinguishing a corporate "reshuffling" from an exchange giving rise to discount or loss, the Supreme Court stated that "there has been no new capital acquired and no additional cost incurred in retaining the old capital". In the instant case, Cities clearly has incurred an additional cost of retaining the old capital.

But for the intervention of the SEC, the history of purchases by Cities shows that it would have been able to retire the preferred at a cash price approximating one-third of the principal amount of the debentures it was required to issue. (137a-139a) Surely the additional cost is a cost of "retaining the old capital".

Cities also submits that the extensive quotations from the *National Alfalfa* case in the Government's Brief are very misleading because they imply that the same facts obtain in the instant case as obtained there. In *National Alfalfa* the principal amount and interest rate on both the preferred and the debentures was the same, both entailed sinking funds in the same amount, and the amount originally paid in for the preferred equalled the principal amount of the debentures—the ultimate obligation. No such similarities existed regarding the securities in the instant case. As previously pointed out herein, the weak, unprotected preferred and preference shares were replaced with debentures greatly exceeding in principal amount both the amount paid in for, and the stated value of, the preferred, with different interest rates and with generous protective provisions, including a sinking fund, and a fixed maturity date.

Contrary to the Government's allegation, the Securities and Exchange Commission and the United States District Court of Delaware did not find that the 3% debentures were "substantially equal to the preferred stock received" (Gov't. Br. p. 14) in the sense that the *principal amount* of the debentures was equalled by the value of the preferred and preference shares. Both the SEC and the Delaware Court held that the two securities would be equitably equivalent in "investment value" to their holders and it was clearly assumed and expected that such "investment value" would be substantially less than the principal

amount of the debentures. See, *In re Cities Service Co.* (D.C. Del. 1947) 71 F.Supp. 1003; Findings And Opinion of the Commission. (45a, 63a-68a)

This same argument, in proper perspective, simply supports Cities contention that the debentures had a value equal to the amounts paid in for, or at most, the fair market value of the preferred and preference shares.

Contrary to the Government's assertion, there is a great difference between 3% interest payable annually, and in all events, and 6% dividends that merely accumulate. It is specious to contend that 3% interest paid in cash is equivalent to 6% dividends accumulating annually in arrears but not required to be paid.

Likewise, Cities balance sheet entries do not demonstrate a "mere substitution" as the Government alleges. No passed dividends have been "carried as earned surplus". The mere creation of a surplus reserve does not constitute a promise to pay or create an enforceable liability or even bestow a benefit on it which a corporation doesn't otherwise have. Charges to such account, however, may constitute a detriment to the corporation if such charges are eventually paid out in cash. A corporation acquires its funds only from stockholders, creditors, or from earnings and it pays its obligations only from those sources.

Any payments, whether loss, interest or other expense, except for repayment of paid-in capital or repayment of borrowed funds, must be charged against earnings and thus against earned surplus. If it repays to its shareholders, current or former, more than it received from them, the excess of repayments over contributions must come from earnings or earned surplus. If it pays its creditors more than it borrowed from them the excess and any interest

must come from earned surplus, like any other expense or loss attributable to doing business.

The exchange in the instant case did *much more* than shift items from the equity account to the debt account. It caused Cities to remove the stated value of the preferred from the equity account and the difference between stated value and the principal amount of the debentures was removed from earned surplus or charged against current or future earnings. The latter amount is the cost to Cities of retaining the former.

Contrary to the Government's assertion, a deduction was not denied in *National Alfalfa* because the equity account was labeled "stated capital." It was denied because the *only* effect on NAD was the transfer of the identical amount from the equity capital account to a substantially similar debt capital account and no additional "cost" was *charged or chargeable* against earned surplus. Obviously, the market value of the preferred was of little or no consequence in such context. By issuing the bonds, NAD neither paid nor obligated itself to pay, more than it originally received. Thus, *National Alfalfa* established that additional cost of capital is the very essence of loss or discount. Here Cities became unconditionally liable to repay $115,246,950 for which it had originally received $45,323,846. The $86,313,600, as Judge Tenney found in the Court below, represents the value of both the preferred and preference shares and the 3% debentures issued in exchange therefor. In respect of the preferred and preference shares no "attendant obligations" of the equity account were cancelled in excess of $58,690,000, the stated value of such shares. The preferred and preference shares had no binding legal claim on the earned surplus for the dividend arrearages. If they had such a claim, there would have been no occasion for the intervention of the Securi-

ties and Exchange Commission. It is not legally arguable that insofar as the preferred and preference shares are concerned the dividend arrearages or earned surplus are "equity accounts". (See argument under Point III, *infra.*)

Point III

Contrary to the Government's contention in Point III of its Brief, the trial court did not allow Cities to deduct discount attributable to dividends and call premium. It allowed Cities to deduct *discount* incurred by it in an amount equal to the difference between the principal amount of the 3% debentures and the fair market value of the preferred and preference shares. The distinction is very important! It is a distinction properly and clearly made by the Securities and Exchange Commission, by the District Court for Delaware and twice by the Court below.

The fact is that this argument is, in substance, a repetition of the same equals-for-equals argument made over and over again in this case and rejected repeatedly as untenable. Basic to its viability are several assumptions that are really not valid, available or applicable in the case:

1. The argument assumes that the Securities and Exchange Commission ordered a *redemption* of the preferred and preference shares, whereas it specifically refused to do so and specifically stated that it had not done so.

2. The argument assumes that the arrearages of dividends and call premium constituted valid, binding, and matured legal obligations of Cities payable in any and all events, whereas they were not and the Securities and Exchange Commission and the Court below said they were not.

3. The argument assumes that the market value of the 3% debentures was equal to their principal amount or face value, whereas the record shows that they were not, and the Securities and Exchange Commission and the Delaware District Court said they were not.

4. The argument assumes that the market value of the 3% debentures was equal to their principal amount or face value, whereas the Securities and Exchange Commission held, and the record discloses, that the 3% debentures were equal to the value of the preferred and preference shares which, at maximum, was $86,313,600.

5. The argument assumes that the promise to pay $115,246,950 thirty years hence was worth $115,246,950 in immediate cash, whereas the records shows that Cities was absolutely unable to retire all of the shares for cash and it was extremely hazardous to issue debentures therefor in view of earnings prospects and economic conditions. Long term debt is far from the absolute equivalent of immediate cash especially when the financial condition of the debtor is as weak as Cities' was at the time of the exchange.

It should be noted that all of these matters argued by the Government were conclusively decided years ago and should now be considered the law of the case. It is not now open to the Government to say again that something was intended other than what was done, and exact a tax on the basis of what it asserts was intended or on what it asserts might have been done. The *National Alfalfa* case, so completely relied upon by the Government, clearly points out that rule of law. 42 U.S.L.W. 4802. It might be that a mere alteration of the capital structure without more

precludes loss or discount, but Cities submits that far more occurred in the instant case. Here, the hearings and investigation by the Securities and Exchange Commission the adversary nature of the proceedings, and the public resolution of the controversy in addition to an active market constituted a more than adequate substitute for the "market forces" and clearly prevented the transaction from being "insulated from the market processess" or being classified as "intra-corporate and private" *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 42 U.S.L.W. 4802, 4803.

In repeatedly posing this "equals-for-equals" argument, the Government misconstrues the action taken by the Securities and Exchange Commission which absolutely and positively did *not* consider the face amount of the debentures as constituting payment of the full call price of the preferred when it found the Plan "fair and equitable". The quotation in the Government's Brief (p. 18) from the SEC report clearly proves that there was no such payment. The SEC merely pointed out that the *investment value* of the debentures would be approximately the same as the investment value of the preferred and preference shares and the plan was thus fair and equitable *to the preferred and preference shareholders.* The quotation *also* points out the extreme unlikelihood that Cities could redeem or refinance its preferred stocks, which finding itself refutes the Government's argument in this case. The SEC merely held that the preferred and preference shareholders *eventually* would receive the same amount as they would have received upon a call of the shares, provided, of course, that they held the debentures to maturity and the obligation was paid in full at that time. It did not hold that the shares were worth the face amount of the debentures. It, in fact, held that neither the preferred nor

the debentures were worth the face or principal amount of the debentures.

The Government in its Brief (pp. 18-20) completely misconstrues the Findings and Opinion of the SEC regarding the Cities Service Co. simplification plan and is in error in accusing Judge Mansfield in the Court below of collaterally attacking the SEC determination. Judge Mansfield did not attack the Findings and Opinion of the SEC. To the contrary, he gave effect to them. (See the extensive discussion by Judge Mansfield at 151a-157a.) It is the Government here which seeks to twist portions of the SEC findings out of context and use them to support its position in this case. The Government's entire case is bottomed on the proposition that the SEC determined that the preferred and preference shares and the 3% debentures were worth the principal amount of the debentures in cash on the day of the exchange. This proposition is just not true. The SEC so held, the Delaware District Court so held, and the Court below so held. On this point they all should be affirmed.

CONCLUSION

1. Cities Service Company is entitled to loss deductions in 1953 and 1954 on account of the retirement of $1,519,500 and $1,805,900, respectively, in principal amount, of its 3% debentures in such years at a price in excess of the amount received for said debentures, such loss being measured by the difference between the amount paid to retire the debentures and the amount received for them.

2. Alternatively, Cities Service Company is entitled to debt discount deductions in 1953 and 1954 on account of the annual amortization of the difference between the principal amount of its 3% debentures issued in 1947 and the amount received for them, plus the unamortized discount on debentures retired in such years.

3. In computing its additional deduction for unamortized discount on debentures retired in 1953 and 1954 no reduction may properly be made for prior years amortization allowable but not deducted.

Respectfully submited,

Dated: New York, New York
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Thomas E. Tyre

Attorney for Cities Service Company
330 Madison Avenue
New York, New York 10017
(212) 490-8445

Of Counsel:

Casey, Craig & Constance
330 Madison Avenue
New York, New York 10017

James W. Robinson
Frueauff, Farrell, Sullivan & Bryan
60 Wall Street
New York, New York 10005

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Paul J. Curran

UNITED STATES ATTORNEY

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